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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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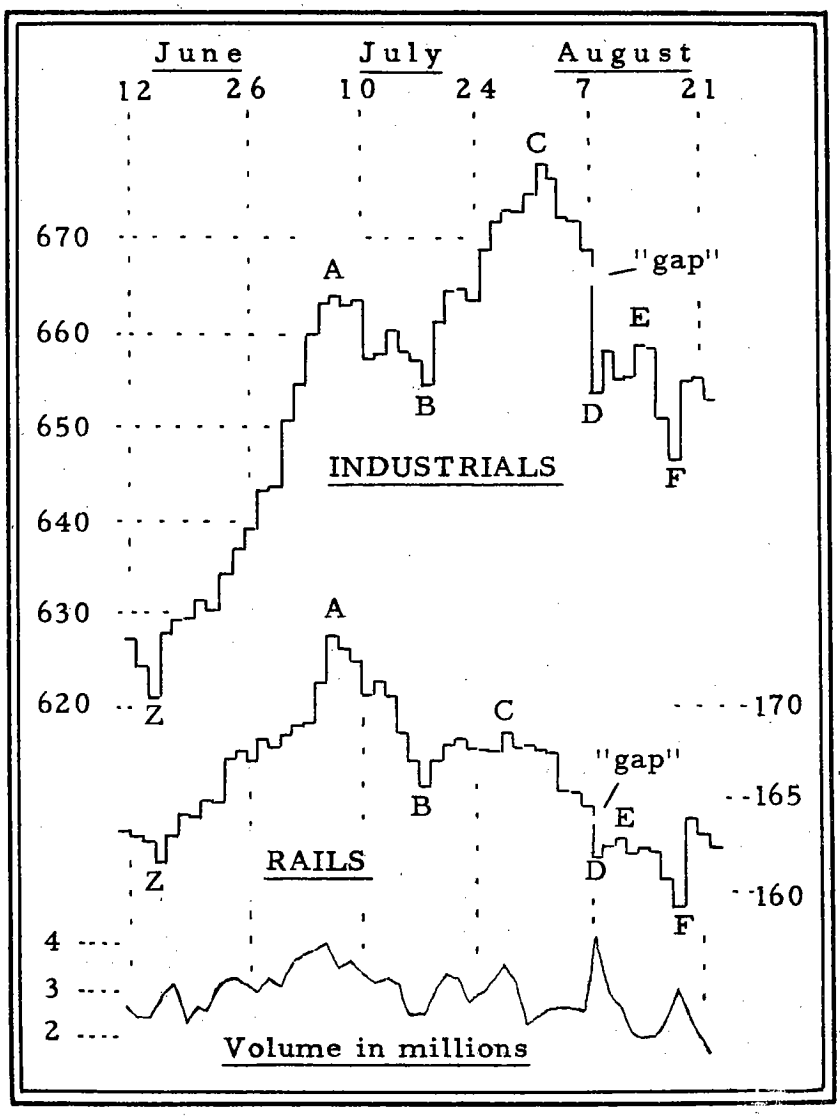
EYES ON TOMORROW. Last week, while a spirit of general optimism prevailed throughout the nation, the impersonal averages again said, "be careful". Readers might remember, as they examine the glowing financial reports in their daily newspapers, that the market has a habit of ignoring the obvious and looking ahead. The many impressive and readily available business indices tell us what has happened and perhaps what is happening -- never what is going to happen. "The superficial observer," wrote Hamilton, "is constantly startled to find that the stock market fails to respond to sudden and important developments, while it seems guided by impulses too obscure to be traceable. Consciously or unconsciously, the movements of prices reflect not the past but the future."

CURRENT MARKET. The high-volume violation of the B points (see chart) was discussed in Letter 75. At that time I said that caution was warranted because: (1) the industrial high at C had not been confirmed by a corresponding rail high, (2) following this non-confirmation, both averages had turned down and violated their previous decline lows (at B) on high volume (the first such action since the 1957 lows), (3) this penetration had taken place following an extended and uncorrected primary advance. I also wrote that it would be normal for a rally to correct about one-half of the C-D losses. Subsequent to the D points, the two averages advanced feebly as volume diminished (on two successive days volume dropped under 2 million shares). It became rather obvious at point E that the rally lacked conviction, and on August 18 both averages turned down again to crack their second set of decline lows (the D points) on increased volume. The next day, despite a late rally, both averages ended lower as volume picked up to 3 million shares. A surprising advance occurred on August 20 with both averages registering sharp gains -- yet volume dropped to 2.4 million shares on the move. The week ended on a divergent note; industrials rose a fraction, rails weakened, and volume fell to 2 million shares.



This week began with volume contracting drastically as both averages worked lower. Although one day's indications are never conclusive, the lack of downside pressure was encouraging.

THE SIGNS. Because of the two successive penetrations of previous low points on increased volume, the second-

ary trend of the market is now in doubt for the first time in 21 months. If the averages continue to plot a series of downward zig-zags (such as C-D-E-F) with volume tending to increase on declines and decrease on rallies, the chances of a full-scale secondary reaction will be excellent. If, on the other hand, the two averages hold above their last low points at F (industrials 646.53, rails 159.25), and on the next approach to those lows volume diminishes sharply as one or both averages hold above the F points, it will be the first sign of a halt in the downward trend (and perhaps a "buy-spot" for venturesome traders). Following this, if both averages commence tracing a series of upward zig-zags with volume tending to expand on higher prices and contract on lower prices the picture will appear decidedly more hopeful. But because of the recent series of downward penetrations, the secondary trend cannot be reaffirmed as bullish until both averages better their previous highs (industrials at C -- 678.10, rails at A --173.56).

VOLUME INDICATIONS. An analysis of the recent price-movements taken together with volume suggests the need for caution at this time. The upward action of the averages over the last few months may be divided into three separate advances: (1) Z-A, (2) B-C, (3) D-E. Volume on each of these rallies has tended to diminish, growing weakest at D-E. Moreover since the industrial high point at C, volume has tended to increase on lower prices (particularly at points D and F). In other words, selling pressure is increasing and buying power is diminishing, never a bullish phenomonon. I say this while taking into account the fact that this is the phase of a bull market which finds the public heavily invested. It is usual for action in the third phase of a bull market to be more erratic and more difficult to interpret than in any other period. When the public is in the market the news of the day has far more effect on daily action than is normally the case. Newspaper headlines, advisory service recommendations, tips and rumors can bring in a flood of buy or sell orders and this exaggerates the minor or daily movements.

AGING THIRD PHASE. The current third phase will be two years old this October. By bul market standards, it is no longer a baby. For this reason I believe it is worth while repeating Robert Rhea's wise words regarding reactions in the third phase of a bull market:

> "It is in the third phase of a bull market that the most danger lies for the investors, because they (as distinguished from speculators) generally decline to practice the art of retreating when secondary reactions develop. Investors seem to prefer to sit tight on their holdings during these disturbances, and this trait tends to develop a false sense of security; they begin to think that each recession will be followed by new highs in due time, and that, consequently, recessions should be ignored. Ultimately such an investor attempts to ride through a decline which proves to be not a recession but the beginning of a primary bear market".

QUESTION. At what point would you call this a secondary reaction?

ANSWER. Secondaries tend to last three weeks to three months; they tend to correct 1/3 to 2/3 of the previously uncorrected primary swing. As of this writing, the decline from C on industrials and A on rails has been of sufficient duration to fit the definition of a secondary. The extent of the move, however, is still far short of the required retracement. At the recent highs industrials were 258 points and rails 77 points above the October, 1957 lows. If industrials moved into the 600-620 area and rails into the 145-55 area I would say that the drop could be classified as a secondary.

QUESTION. What would now constitute a bear signal?

ANSWER. We are not even sure that a secondary reaction is on the way. But assuming a full secondary were to take place, we would then wait for the advance which would serve to correct the secondary. If on this advance one or both averages failed to better the previous highs (industrials 678.10, rails 173.56) and both averages then turned down and violated the secondary reaction lows, at that point we would say that a bear signal had been given. In other words, a bear signal can only be given when a bull market is in its third phase and

following a secondary reaction.

QUESTION. What is the significance of the gaps produced in the averages on the recent break?

ANSWER. Downside gaps are produced when the lowest intra-day prices on a given day are above the highest intra-day prices of the following day. This forms gaps or spaces on the charts. The Dow Theory gives no credence to gaps or intra-day prices, and on a chart of closing prices only, gaps do not appear. There is an old market adage which says, "Gaps are always filled." As far as I am concerned it is an old wives' tale. In fact, hundreds of gaps established during 1929-30 (on individual stocks) still have not been filled.

A TREND. During the last eight months the market as measured by the D-J industrials has advanced irregularly about 10%. Rails have moved in an even narrower area. During all this time the financial pages of the newspapers have been well decorated with such ads as "3 Stocks to Retire On" and "7 Stocks to Triple". I have mentioned that it is difficult to make money when one comes in with the public, and 1959 has been a good case in point. It is axiomatic that stocks are seldom bargains when the public is ready to buy them.

A great deal is written these days about individual stocks, and security analysts are loudly proclaiming that this is "a market of stocks, not averages." The fact remains, nevertheless, that profits are usually made when the broad trend of the market is up and when it remains up for a goodly length of time. I have spoken to a number of experienced operators over the last few weeks, and most complain that they have barely avoided losses (on average) on all their 1959 transactions.

I have been watching one service which claims that it can make money for its subscribers n any kind of market. "There are always a few stocks or groups which are in bull markets of their own", they state. But this outfit "grinds" an understandable axe, for it deals not in a method of market operation (few services do) but in naming stocks which should be bought or sold. I note, however, that they have been rather unsuccessful in their choices this year; yet they still stick to their guns in insisting that money can always be made. I am sure that it can, but without an impressive primary swing they do not seem to be the ones to do it. For that matter, I have not yet discovered anyone who can.

PERSONAL OPINIONS AND OBSERVATIONS. Watch the uncertain action of the short-term money market. Letter 70 (June 25) spoke of the bear market in bonds, and that situation is developing rapidly. There are already signs of pressure on the new 4.75% treasury notes of 1964 (they took a sharp drop last Friday, despite the fat yield).

Mutual savings banks added 304 million of new deposits for the first four months of this year vs. 818 million for the same period last year. With the U.S. Treasury forced into the short-term money market, this trend could get a lot worse. How the savings banks and savings and loan outfits are going to keep deposits coming in (with treasury notes yielding up to 4.6%) is beyond me.

It seems to me that the current situation differs from the 1920's in that the greatest speculation has so far taken place in the economy, not in the stock market. The Government, corporate, and consumer debt structure is now huge; this was not so in the 1920's. For this reason I am growing less certain of the necessity for volume of 6-8 million shares (as in 1928-29) prior to a final top. There is usually a "fooler" in every bull market top -- this could be it.

Tight money and inflation do not go together. Inflation is caused by too much money and not enough products. Some observers believe that we have already passed the inflation top, and that prices of "things" may now level or head down. Inflation has been one of the big arguments for a continued stock market boom.

(Written August 24 - after the close.)